United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

75-7404

To be argued by

Martin A. Coleman
and Burton L. Knapp

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P/S

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 75-7404

ARNOLD MARSHEL,

Plaintiff-Appellant,

v.

AWF FABRIC CORP., CONCORD FABRICS, INC.
ALVIN WEINSTEIN and FRANK WEINSTEIN,

Defendants-Appellees.

BARRY L. SWIFT,

Plaintiff-Appellant,

v.

CONCORD FABRICS, INC., AWF FABRIC CORP.,
ALVIN WEINSTEIN and FRANK WEINSTEIN,

Defendants-Appellees.

Appeal from Order of the United States District
Court for the Southern District of New York
Denying Preliminary Injunction

BRIEF OF PLAINTIFFS-APPELLANTS
ARNOLD MARSHEL and BARRY L. SWIFT

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TABLE OF CONTENTS

	Page
Issues Presented for Review	1
Preliminary Statement	3
The Facts	7
Point I - The Lack of any Corporate Business Purpose of Concord being Conceded, A Coercive, Freeze-out Merger Accomplished with the use of Corporate Assets and Intended for the Personal Profit of Those in Control, is Invalid under New York and Federal Law	13
A. "Going Private" - An Overview	13
B. "Going Private" and Fiduciary Duty	16
Point II - The Board of Directors' Resolutions which were Necessary to Proceed with any Merger are Invalid in the Admitted Absence of a Proper Corporate Business Purpose of Concord	18
A. The Concord Directors Failed to Meet the Requirements of the New York Business Corporation Law	18
B. Formal Compliance with the New York Merger Statutes Does not Relieve the Concord Directors of their Fiduciary Duties	21

Page

Point III - A Preliminary Injunction, Not Appraisal, is the Proper Remedy When Directors Violate the Federal Securities Law, or Fail to Discharge their Fiduciary Duties to Act in the Interest of the Corporation and All Its Shareholders........................... 25

A. The Existence of Appraisal Rights Cannot Legitimitize an Unlawful Transaction............................. 25

B. The District Court Misinterpreted The New York Authorities................. 27

POINT IV - The Proposed Merger and the Steps Taken in Connection Therewith Violate Section 10(b)........................ 31

Conclusion... 38

Decision in People v. Concord Fabrics Inc., Supreme Court New York County, June 13, 1975............ 39

Addendum of Statutes, etc. 40

TABLE OF AUTHORITIES

Page

Cases

Albright v. Bergendahl, [1974-75 Transfer Binder] CCH Fed. Sec. L. Rep., ¶94,997 (D. Utah, Sept. 5, 1974) 17, 26

Beloff v. Consolidated Edison Company of New York, Inc., 300 N.Y. 11 (1949) 27, 28

Blumenthal v. Roosevelt Hotel Corp., 202 Misc. 988, 115 N.Y.S.2d 52 (Sup. Ct. 1952) 27, 28

Bryan v. Brock & Blevins Co., Inc., 490 F.2d 563 (5th Cir.), reh. en bank denied, 493 F.2d 664, cert. denied, 419 U.S. 844 (1974) 17, 25

Cochran v. Channing Corp., 211 F.Supp. 239 (S.D.N.Y. 1962) 18

Dempster Brothers, Inc. v. Buffalo Metal Container Corp., 352 F.2d 420 (2d Cir. 1965), cert. denied, 384 U.S. 940, reh. denied, 384 U.S. 1027 (1966) 6

Dopp v. Franklin National Bank, 461 F.2d 873 (2d Cir. 1972) 6

Drachman v. Harvey, 453 F.2d 722 (2d Cir. 1972) (en banc) 33, 34

Eisenberg v. Central Zone Property Corp., 306 N.Y. 58 (1953) 28, 29, 30

Electronic Specialty Co. v. International Control Corp., 409 F.2d 937 (2d Cir. 1969) 18

Foley v. D'Agostino, 21 A.D.2d 60, 248 N.Y.S.2d 121 (1st Dept. 1964) 19, 23

Gulf & Western Industries, Inc. v. Great Atlantic & Pacific Tea Co., 476 F.2d 687 (2d Cir. 1973) 33

Page

Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185 (1919).. 21

Mutual Shares Corporation v. Genesco, Inc., 384 F.2d 540 2d Cir. 1967)................................... 36

People v. Concord Fabrics, Inc., N.Y.L.J., June 13, 1975, p. 15, col. 2 (Sup. Ct. N.Y. Co.)................ 5, 26, 30

Pepper v. Litton, 308 U.S. 295 (1939).................. 16

Popkin v. Bishop, 464 F.2d 714 (2d Cir. 1972).......... 32

Rosenfeld v. Black, 445 F.2d 1337 (2d Cor. 1971) Pet. for cert. dismissed sub. nom., Lazard Freres & Co. v. Rosenfeld, 409 U.S. 802 (1972)................ 3, 20

Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374 (2d Cir. 1974) cert. denied, U.S. (1975)...... 34

Securities and Exchange Commission v. Spectrum, Ltd., 489 F.2d 535 (2d Cir. 1973)...................... 6

Speed v. Transamerica Corporation, 99 F.Supp. 808 (D. Del. 1951)....................................... 18

United States v. Byrum, 408 U.S. 125, reh. denied, 409 U.S. 898 (1972)................................. 23

Van Gemert v. The Boeing Co., Docket Nos. 74-1157-59, 74-1165, 74-1185 (2d Cir. July 14, 1975)... 24

Willcox v. Stern, 18 N.Y.2d 195 (1966)................. 27, 28

Page

Statutes and Consequential Rules

Securities Exchange Act of 1934, Section 10(b), 15 U.S.C. §78(b) 2, 4, 31, 32, 34

General Rules and Regulations under the Securities Exchange Act of 1934, Rule 10b-5, 17 C.F.R. §240.10b-5... 2, 4, 31, 34, 36

New York Business Corporation Law

Section 202 19

Section 623(k) 29, 30

Section 717 .... 19, 20, 23

Section 902 .... 18, 19, 28

Section 903 .... 18, 19, 28

Section 905 28

Articles and Commentaries

Borden, "Going Private -- Old Tort, New Tort or No Tort," 49 N.Y.U. L. Rev. 987 (1974) 14

Brudney and Chirelstein, "Fair Shares in Corporate Mergers and Takeovers," 88 Harv. L. Rev. 297 (1974) 14

Sommer, "Going Private" -- Speech by Commissioner of the Securities and Exchange Commission, [1974-75 Transfer Binder] CCH Fed. Sec. L. Rep. ¶80,010, at p. 84,695 13

Vorenberg, "Exclusiveness of the Dissenting Stockholder's Appraisal Right," 77 Harv. L. Rev. 1189 (1964) 26

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BRIEF OF PLAINTIFFS-APPELLANTS
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ISSUES PRESENTED FOR REVIEW

1. Does a long-form merger in formal compliance with the New York State Business Corporation Law, but which concededly serves

no corporate business purpose and has as its admitted sole objective a freeze-out of public minority shareholders of a listed corporation and the transfer of all of the corporate assets to those in control, constitute:

(A) an "act, practice or course of business which operates or would operate as a fraud or deceit" within the meaning of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5; or

(B) a breach by controlling shareholders of their fiduciary duties to the corporation and its minority shareholders under the statutory and common law of New York rendering the required merger resolutions invalid and the proposed merger legally incapable of being consummated?

2. Is an appraisal proceeding the exclusive remedy of minority shareholders under New York law when there is fraud, illegality, and overreaching on the part of corporate fiduciaries in connection with a freeze-out merger which serves no business purpose?

3. Did the district court abuse its discretion in denying a preliminary injunction against a merger in a derivative action where there was concededly no business purpose for the merger and its consummation prior to trial would result in the complete elimination of a public market for the corporation's stock and its status

as a public corporation and cause the corporation to expend over one million six hundred thousand dollars without a business purpose for that expenditure?

Preliminary Statement

Plaintiffs, minority shareholders of Concord Fabrics, Inc. ("Concord"), a publicly-held corporation shares of which are listed on the American Stock Exchange, appeal from an order of the United States District Court for the Southern District of New York, MacMahon, J., dated June 24, 1975, insofar as it denied applications made in four related actions for a preliminary injunction to enjoin a plan conceived by Alvin and Frank Weinstein, Concord's controlling shareholders, to "go private" by means of a freeze-out merger been Concord and AFW Corp. ("AFW").* AFW was organized by the Weinsteins as a corporate entity solely for the purpose of effectuating the proposed merger. Defendants have conceded that the transaction serves no business purpose of Concord. The district

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* The other actions are: Michaels v. Weinstein (75 Civ. 1027-LFM) and Krause v. Concord Fabrics, Inc. (75 Civ. 1064-LFM). The plaintiff in Swift originally filed suit in the Supreme Court of the State of New York, New York County. He voluntarily dismissed that action after the three suits were instituted in the District Court in the interest of presenting in one forum all issues of federal and state law pertaining to "going private" transactions and to comply with the admonition contained in Rosenfeld v. Black, 445 F.2d 1337, 1341 n.5 (2d Cir. 1971) pet. for cert. dismissed sub nom. Lazard Freres & Co. v. Rosenfeld, 409 U.S. 802 (1972).

court's opinion is not yet officially reported but appears in [Current Binder] CCH Fed. Sec. L. Rep., ¶95,219.

The Marshel and Swift actions, which are the subject of this joint appeal, present all of the issues of federal and state law involved below. Marshel is a derivative and class action the amended complaint in which asserts claimed violations of the federal securities laws, including Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and consequent Securities and Exchange Commission Rule 10b-5, and pendent claims under New York law. The Swift action does not arise under the federal securities laws. Federal jurisdiction of the Swift action is premised on diversity of citizenship. The Swift action is grounded squarely on New York statutory and common law applicable to fiduciary obligations in the corporate context. Both the Marshel and the Swift actions were brought derivatively, on behalf of Concord, to prevent waste by fiduciaries of corporate assets and representatively, on behalf of the public minority shareholders of Concord, to prevent substantial and irreparable investment losses should the merger be consummated.

On April 7, 1975, subsequent to the institution of the private actions described above, and while plaintiffs' motions be-

low were sub judice, the Attorney General of the State of New York commenced an action in the Supreme Court of the State of New York, New York County, to enjoin the proposed merger under the authority granted to him by Article 23-A of the General Business Law of the State of New York. Mr. Justice Markowitz preliminarily enjoined the AFW-Concord merger, stating:

> "What is disquietingly evident here is the fact that a group of insiders who are directing the reacquisition program, even controlling the appraisal of the stock are the very ones who made the company public originally, and will be the surviving shareholders in the proposed privately-held enterprise. Adding to the odium of the scheme is that fact that no real corporate purpose has been demonstrated and that the credit of a now public corporation will be used to finance a merger for the benefit of a private group." People v. Concord Fabrics, Inc., N.Y.L.J., June 13, 1975, p. 15, col. 2.*

Although called to its attention, the district court, in its opinion below, failed to note or take account of Mr. Justice Markowitz's decision and misinterpreted two New York decisions involving "short-form" mergers where, in contrast to the "long-form" merger involved here, no directors' resolutions of the subsidiary corporation are required and no business purpose of the subsidiary need be shown.

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* A copy of the opinion is annexed as an appendix to this brief.

It should be noted that no live testimony was taken before the District Judge on plaintiffs' motions for a preliminary injunction. The motions were decided exclusively on the basis of affidavits and documentary evidence submitted by the respective parties. Appellants are of course cognizant of the general doctrine that this Court will not normally interfere with the discretion of the district court to grant or deny a motion for a preliminary injunction. This doctrine, however, does not apply where, as here, there has been no live testimony and the record before the district court consists exclusively of written evidence. As this Court recently recognized in Securities and Exchange Commission v. Spectrum, Ltd., 489 F.2d 535, 540 (2d Cir. 1973) -- reversing the denial of a preliminary injunction in a securities case -- "we need give no special deference to the district court's finding...for 'we are in as good a position as [he] to read and interpret the pleadings, affidavits and depositions'". Accord, e.g., Dempster Bros, Inc. v. Buffalo Metal Container Corp. 352 F.2d 420, 423 (2d Cir. 1965), cert. denied, 384 U.S. 940, reh. denied, 384 U.S. 1027 (1966); and Dopp v. Franklin National Bank, 461 F.2d 873, 879 (2d Cir. 1972).

It is submitted that a review of the record herein must lead this Court to the conclusion that the district court erred. As will hereinafter be demonstrated, defendants have violated

both federal and state law and a preliminary injunction must issue.

THE FACTS

The facts set forth in the moving papers below are largely undisputed and need be only briefly summarized herein.

Concord, a New York corporation, became a public company in 1968 through a sale of 300,000 shares of its common stock to investors at $15 per share, realizing gross proceeds of $4,500,000. (36).* The sale price was almost 300% of Concord's net asset value at that time of $5.18 per share. (37). Less than a year later, the brothers Weinstein sold for their personal accounts another 200,000 shares of Concord common stock for $20 per share, realizing, before expenses of sale, proceeds of $4,000,000. (36).

Concord has prospered as a publicly-held company, and although Concord, as an inducement for investors to purchase its stock, paid dividends for a while, this policy was discontinued and not resumed although the company had and has ample resources for such purposes. As of February 2, 1975, Concord's reported net worth was approximately $13 million, equal to $7.82 per share. (70).

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* Page references in parentheticals are to the Appendix filed by appellants herein.

In late 1974, at just about the nadir of the 1974 bear market when the vast majority of securities listed on the American Stock Exchange had plunged sharply in price, and the price of Concord's common stock had declined to approximately $1 per share, the Weinsteins embarked upon a plan to revest in themselves 100% ownership of Concord.

On or about January 29, 1975, the Weinsteins organized AFW with an authorized capital of 2,000,000 common shares. The Weinsteins thereupon transferred to AFW 1,226,549 shares of Concord common stock representing 68% of the total number of such shares outstanding, receiving in exchange the same number of AFW shares. On February 6, 1975, the Weinsteins caused AFW to make an Offer to Purchase shares of Concord common stock to all minority shareholders of Concord at $3 per share, some 40% of the reported book value of Concord stock, bluntly informing those public minority shareholders that if they chose not to tender their stock they would later be eliminated through a freeze-out merger with AFW at the same $3 per share. (24). The choice thus given to the Concord public minority shareholders was between an immediate or a deferred eclipse of their equity interest in Concord.

The obvious purposes of the initial tender offer at $3 per share were to manipulate the market price of Concord common stock so that it would not rise above $3 per share upon any general

stock market resurgence and to panic the Concord public minority shareholders into hasty tenders of their stock. If this strategy had succeeded in inducing a sufficient number of tenders, the number of outstanding Concord shares would have dropped below the requirements for listing on the American Stock Exchange, and the Concord shareholder population would have been reduced to below 300, thus permitting delisting and deregistration of Concord as a "reporting company" pursuant to Section 12(g)(4) of the Exchange Act. Under those circumstances, a long-form merger would not have been necessary. It would then have been a simple matter for the Weinsteins to eliminate the remaining minority interest by a short-form merger, or they could have allowed the holders of the remaining minority interest to remain in place without access to information about the then deregistered Concord and without a market in which to sell their shares. Finally, if the initial tender offer succeeded, defendants would have avoided the necessity of issuing proxy material for the merger which was bound to expose the fact that the merger served no business purpose of Concord and that the real purpose was from the outset only to enrich the Weinsteins with the public shareholders' money.

Almost immediately after the commencement of the <u>Marshel</u> action on February 28, 1975, in which a motion was made to enjoin the tender offer, defendants withdrew the tender offer since they

did not desire to explain to a court why the tender offer had been made at the same time that a "merger" was pending. Instead, defendants decided to rely entirely upon the New York merger statutes as authority for their freeze-out of the public. This change in plan necessitated dissemination of Concord's proxy material. (66-103). Any doubt that the transaction was conceived solely in the personal interests of the Weinsteins was thus resolved by March 17, 1975, when the definitive proxy statement was disseminated with the confession:

> "The purpose of the proposed merger.....is to return the Company to the status of a privately-held corporation owned by the Weinstein family. Upon consummation of the merger, the Weinsteins will be the sole stockholders and directors of the Company, and will thus be able to determine all policies of the Company, such as salaries for themselves and others, dividends and business activities, without public scrutiny and solely with regard to their own interests." (68).

This confession that the merger served no business purpose of Concord was compelled by the fact that Concord's preliminary proxy material filed with the Securities and Exchange Commission had stated, at page 3 thereof, that a purpose of the merger was to permit the Weinstein family to operate Concord's business "without the expense or other possible disadvantages of a public corporation." (115). In its letter of comment, the Commission requested Concord to set forth "the amount of the approximate expenses each

year due to being a public company and ... 'other possible disadvantages of being a public company' if such discussion is retained. Reference should also be made to the advantages to shareholders of a public corporation." (117).

In the face of the Commission's comments, defendants dropped from the proxy material any reference to "the expenses or other possible disadvantages of a public corporation." Obviously such expenses could not, by any stretch of the imagination, have exceeded even the interest costs on the more than $1,600,000 which Concord's directors intend for Concord now to disburse in connection with the efforts of the Weinsteins to take Concord private. Thus, defendants abandoned any pretense in their proxy material that the freeze-out merger would in any way be beneficial to Concord. Accordingly, in their papers below, defendants were forced to state:

> "...since as a matter of law business purpose is irrelevant, defendants do not assert on this motion that there was any purpose to the merger other than to return Concord to private ownership by the Weinstein family." (47-48).

The proxy statement discloses that although there was no business purpose for the merger, the Weinstein brothers would benefit handsomely at the expense of the public:

> "The effect of the proposed merger will also be that without any additional investment on the part of the Weinstein family their interest in the stockholders' equity of the Company will be increased from approximately $9,494,000 (representing 68% of the equity as at February 2, 1975) to approximately $12,285,000 (representing 100% of such equity on a pro forma basis, giving effect to consummation of the merger...), and their interest in the Company's net earnings for the fiscal year ended September 1, 1974 will increase from approximately $354,000 (68% of such earnings) to approximately $442,000, being 100% of such earnings on a pro forma basis..." (71).

Finally, the proxy material disclosed that the price of $3 per share proposed to be paid to the public was not the result of independent analysis by Shearson Hayden Stone, Inc., an investment banking firm, but was rather determined by Charles M. Edwards III, an officer of the Shearson firm and the son of a Concord director.

ARGUMENT

I.

THE LACK OF ANY CORPORATE BUSINESS PURPOSE OF CONCORD BEING CONCEDED, A COERCIVE, FREEZE-OUT MERGER ACCOMPLISHED WITH THE USE OF CORPORATE ASSETS AND INTENDED FOR THE PERSONAL PROFIT OF THOSE IN CONTROL, IS INVALID UNDER NEW YORK AND FEDERAL LAW

A. "Going Private" - An Overview

The recent phenomenon known as "going private" has been described as a "perversion of the whole process of public financing."* In simplest terms, going private is an illegitimate

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* Speech by Commissioner A. A. Sommer, Jr. of the Securities and Exchange Commission, on "Going Private" as reported in [1974-75 Transfer Binder] CCH Fed. Sec. L. Rep. ¶80,010, at p. 84,695. The very nature of "going private" presents almost limitless profit opportunities for insiders who are in a unique position to anticipate future favorable trends in corporate operations. For this reason, we deem it highly relevant to the issues before this Court, even though the events occurred subsequent to submission of the motions below, to point out that on July 8, 1975, Concord reported a sharp increase in its net income for the 9 months ended June 2, 1975, to $1,405,000 equal to $.79 per share, as compared to $863,000 equal to $.48 cents per share in the same period of the prior year, while shareholder equity rose to approximately $8.70 per share, as compared to the proposed price of $3 per share sought to be imposed on the Concord minority in the merger.

This disclosure, made after the merger had been temporarily enjoined by Justice Markowitz, precipitated a sharp rise in the market price of Concord stock to over $4 per share, or 1/3 higher that the proposed freeze-out merger price of $3 per share which is still in effect!

child of the bear market of 1974. It is a device used by the unscrupulous to take advantage of temporary market conditions in order to eliminate public shareholders, without their consent -- or even the consent of a majority of such public shareholders -- at distress prices calculated to produce insider profits.* Such tactic, where there is not even a pretense of serving any corporate business purpose, and where corporate assets are used to achieve the result, is clearly a subversion of the time honored doctrines governing fiduciary behavior. In their recent article entitled "Fair Shares in Corporate Mergers and Takeovers," 88 Harv. L. Rev. 297 (1974), Professors Brudney and Chirelstein state that "every consideration of equity argues for a categorical prohibition against the freeze-out." Id. at 324n. See, also Borden, "Going Private - Old Tort, New Tort or No Tort" 49 N.Y.U. L. Rev. 987 (1974) wherein the author, while generally sympathetic to going-private transactions, states that "going-private transactions without the approval of a majority in interest of outside shareholders should be presumed to be at an unfair price." Id., at 1018.

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* Since announcement of the proposed merger in February, 1975, stock values on both major exchanges have increased sharply by $217 billion in the first six months of 1975, erasing most of the 1974 losses, while the average share gained 50.7% in the New York Stock Exchange and 61.4% on the American Stock Exchange. Hart, "Business-Financial Notes", N.Y.L.J., July 10, 1975, p. 3. col. 3. Yet, the public shareholder of Concord remains locked into an arbitrary merger price of $3 per share.

Here, of course, the Weinsteins did not permit the public shareholders to decide the issue. Rather, the public was told, first in the aborted tender offer (24) and then again in the proxy statement (69) that they were not being asked to determine and could not determine, whether to continue public trading of their shares, even if they so preferred. Although only the shares held by the public make up the trading float, since the shares owned by the Weinsteins are not registered under the Securities Act of 1933, and do not trade, the insiders nevertheless arrogated to themselves the determination, which they made unilaterally and without any business reason for Concord and by which they served only their own interests, to call in the public's stock; and they did so at a price which they themselves arbitrarily selected.

Such conduct should certainly be enjoined by a court of equity. Yet, the district court, sitting in both a federal securities case and a diversity of citizenship case, has refused to grant a preliminary injunction. The denial of injunctive relief, on the ground that so-called "full disclosure" and recourse by the public, on an individual basis, to expensive litigation under the New York appraisal procedures satisfies both the federal securities laws and the common law of New York, is surely an abuse of judicial discretion. The district court's determination ignores the fact that the corporation is itself about to be victimized. Once the

merger takes place, Concord's status as a public corporation will be lost. There can be no justification for the conduct of defendants. The failure to enjoin the freeze-out is analagous to condoning robbery provided the felonious intentions are expressed in advance.

B. "Going Private" and Fiduciary Duty

This litigation involves basic concepts of fiduciary duty, which are often forgotten in our rapidly-moving corporate society, but which the courts have properly forced corporate malefactors to recall. The seminal decision of the Supreme Court in Pepper v. Litton, 308 U.S. 295, 311 (1939) expressed the concept of fiduciary obligations in the corporate context in language highly applicable today to the area of "going private":

> "He who is in such a fiduciary position cannot serve himself first and his cestuis second. He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency and honesty. He cannot by the intervention of a corporate entity violate the ancient precept against serving two masters. . . . He cannot utilize . . . his strategic position for his own preferment. . . . He cannot use his power for his personal advantage and to the detriment of the stockholders . . . no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements."

The basic principles enunciated in Pepper v. Litton are valid today, vital to investor confidence and honest markets, and

clearly applicable to the "going private" situation as exemplified by the recent decision of District Judge Ritter in Albright v. Bergendahl, [74-75 Transfer Binder] CCH Fed. Sec. L. Rep., ¶94,997 (D. Utah, Sept. 5, 1974), in which it was held that a freeze-out merger on terms strikingly similar to those involved here not only violated Rule 10b-5, but also that:

> ". . . such conduct constitutes a breach of their fiduciary duties of these defendants to the public minority of stockholders of International Service Industries, Inc." (Emphasis supplied.) Id. at 97,453.

In the widely-acclaimed decision of the Fifth Circuit Court of Appeals in Bryan v. Brock & Blevins Co., Inc., 490 F.2d 563 (5th Cir.), reh. en. banc denied, 493 F.2d 664, cert. denied, 419 U.S. 844 (1974), that court held that the power of majority shareholders to effect a freeze-out merger is restricted by a requirement of valid business purpose, in the absence of which a merger will be enjoined as a breach of the majority's fiduciary duties to the minority. In affirming the district court on the issue of state corporation law, the court stated that it approved the trial court's holding that:

> "[W]here a corporation is unable, because of well recognized contract law to eliminate a minority stockholder by simply adopting a by-law or voting to purchase his stock, its majority stockholders cannot accomplish the same purpose by setting up a second corporation wholly owned by them whose sole purpose is to enable it to take advantage of the

> merger statutes which, when utilized by two existing corporations, may, as a part of the merger procedures result in the elimination of a dissenter." 490 F.2d at 569.

Where fiduciary duties and other special relationships exist, the broad equitable jurisdiction of the federal courts to grant injunctive relief is most frequently invoked. Cochran v. Channing Corp., 211 F.Supp. 239 (S.D.N.Y. 1962); Speed v. Transamerica Corporation, 99 F.Supp. 808 (D. Del. 1951); and Electronic Specialty Co. v. International Controls Corp., 409 F.2d 937 (2d Cir. 1969).

II.

THE BOARD OF DIRECTORS' RESOLUTIONS WHICH WERE NECESSARY TO PROCEED WITH ANY MERGER ARE INVALID IN THE ADMITTED ABSENCE OF A PROPER CORPORATE BUSINESS PURPOSE OF CONCORD.

A. The Concord Directors Failed to Meet the Requirements of the New York Business Corporation Law.

The Concord proxy statement accompanying the notice of a special meeting of shareholders called to "approve" the merger indicates that it is being pursued in purported compliance with the provisions of Sections 902 and 903 of the New York Business Corporation Law applicable to "long-form" mergers. BCL § 902 requires that the board of directors of each constituent corporation adopt a plan of merger, while BCL § 903 requires that

the board of each constituent corporation, upon adopting the merger plan, submit that plan to a vote of shareholders. The vote of the shareholders was, of course, a mere formality in Concord in view of the individual defendants' 68% controlling interest.

The power granted to corporations and their directors by BCL §§ 902 and 903 does not mean that every merger which formally complies with those provisions must be sustained as authorized and proper. The authority and power granted to corporations and their directors is circumscribed by BCL §§ 202 and 717. Section 202, while granting a corporation the power to do certain acts, including the power to deal in its own shares, specifically requires that such powers be used "in furtherance of its corporate purposes." Section 717 requires that "directors and officers shall discharge the duties of their respective positions in good faith....." See Foley v. D'Agostino, 21 A.D.2d 60, 248 N.Y.S.2d 121, 128 (1st Dept. 1964).

The issue here is not whether the statutory formalities of BCL §§ 902 and 903 have been observed or whether the corporate forms have been properly filled out. The issue is whether the resolutions, purportedly adopted on behalf of Concord by the Weinstein-controlled directors, can be accorded any validity when the transaction authorized thereby is conceded to be without any business purpose for Concord. Defendants no longer pretend the exis-

tence of any business purpose, and they cannot seriously urge that a freeze-out merger with a dummy corporation controlled by them and accomplished solely for their own selfish interests through the use of corporate assets is in the discharge of their "respective positions in good faith" as mandated by BCL § 717.*

For these reasons, any merger resolution purporting to implement the Concord - AFW merger is invalid per se, and that invalidity cannot be cured by a vote at a shareholder meeting, a mere ritual at which minority shareholders are helpless to affect the outcome. Any notion that a shareholder vote in which defendants would vote their controlling block could somehow legalize the transaction is put to rest by the case of Rosenfeld v. Black, 445 F.2d 1337 (2d Cir. 1971), pet. for cert. dismissed sub nom., Lazard Freres & Co. v. Rosenfeld, 409 U.S. 802 (1972). In that case, this Court reaffirmed the continuing vitality of the well-established principle of equity forbidding realization of profit by a fiduciary when dealing with the assets of the trust

*In recommending adoption of BCL § 717, the revisers stated:

> "The adoption of the standard prescribed by this section will allow the court to envisage the director's duty of care as a relative concept, depending on the kind of corporation involved, the particular circumstances and the corporate role of the director." 6 McKinney's Consolidated Laws of New York, BCL § 717, p. 695.

and observed that shareholder ratification would not validate a transaction which constituted a breach of fiduciary duty. This Court stated:

> "Even ratification by the beneficiaries would not save a fiduciary from accountability for any amounts realized in dictating or influencing the choice of a successor unless this was secured with notice that the beneficiaries were entitled to the profit if they wished,... and it is questionable whether even such ratification by a majority of the beneficiaries could bind others or the fund itself." 445 F.2d at 1343.

B. Formal Compliance with the New York Merger Statutes Does not Relieve the Concord Directors of their Fiduciary Duties.

Where formal compliance with statutory procedures is urged as a defense by insiders who seek to justify their usurpation of corporate assets for their own benefit, the courts are alert to penetrate form and examine substance. In substance, the Concord insiders are attempting to use corporate formalities and corporate funds to expropriate for themselves and at no cost to themselves 100% ownership of a valuable going business.

How the New York courts would view the proposed merger may be inferred from Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185 (1919), an early case, which involved a dissolution in technical compliance with the New York corporation statutes, the real purpose of which was to jettison an unwanted minority shareholder.

There, the Court of Appeals reinstated a complaint which had been dimissed below. Defendants were directors of the corporation and stockholders holding two-thirds of the stock in the corporation. They adopted at a meeting of the board of directors a plan to dissolve the corporaton which, in essence, was a plan to freeze-out the plaintiff, a minority stockholder. Defendants relied upon Section 221 of the former General Corporation Law which allowed a dissolution if a resolution to that effect was adopted by the board of directors and consented to at a stockholders' meeting by holders of two-thirds of the outstanding stock. The court was called upon to consider whether good faith on the part of the directors should be read into the language of the statute and held that it must. In speaking of the action of the board, the court stated:

> "Their action must be based upon the belief that the interests and welfare of the corporation and the stockholders generally will be promoted by the dissolution ... It is inconceivable that the legislature intended that the directors, in considering and adjudging the advisability of the dissolution, might consider and hold as a basis in whole or in part for their judgment their own individual desires or interests ... The relation of the directors to the stockholders is essentially that of trustee and <u>cestui que trust</u>. The directors are bound by all those rules of conscientious fairness, morality and honesty in purpose, which the law imposes as the guides for those who are under the fiduciary obligations and responsibilities. They are held, in official action, to the extreme measure of candor, unselfishness and good faith. Those principles are rigid, essential and salutary." 226 N.Y at 193.

The court continued:

> "Obviously, facts are alleged which permit, if they do not compel, the inference that the directors conceived and progressed the scheme of dissolving the corporation, irrespective of the welfare or advantage of the corporation and of any cause or reason related to its condition or future, through the desire and determination to take from the corporation and to secure to themselves the corporate business freed from interference or participation on the part of the plaintiff." Id., at 197.

There is no lack of reported decisions, by both state and federal courts, which reaffirm and apply the fiduciary standards to directors and majority shareholders of publicly-owned companies. In interpreting BCL § 717, the Appellate Division in Foley v. D'Agostino, supra, stated:

> "'Officers and directors of a corporation owe to it their undivided and unqualified loyalty.*** They should never be permitted to profit personally at the expense of the corporation. Nor must they allow their private interests to conflict with the corporate interests. These are elementary rules of equity and business morality. Courts of equity must ever enforce strict compliance with these rules.'" 248 N.Y.S.2d at 138.

To the same effect is the recent comment of the United States Supreme Court in United States v. Byrum, 408 U.S. 125, 137-138, reh. denied, 409 U.S. 898 (1972):

> "A majority shareholder has a fiduciary duty not to misuse his power by promoting his personal interests at the expense of

corporate interests. Moreover, the directors also have a fiduciary duty to promote the interests of the corporation."

Judge Oakes, in his recent opinion in Van Gemert v. The Boeing Co., Docket Nos. 74-1157-59, 74-1165, 74-1185 (2d Cir. July 14, 1975) reaffirmed these principles in language which we submit is particularly timely and appropriate to going private situations:

> "The duty of a listed company to its own securities holders to treat them fairly is founded in fundamental concepts of the law pertaining to corporate fiduciaries. Cohen v. Beneficial Industrial Loan Corp., 337 U.S. 541 (1949); Pepper v. Litton, 308 U.S. 295 (1939); Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir.), cert. denied, 414 U.S. 910 (1973). Security holders of a corporation are in a very real sense creditor beneficiaries, see 1 Restatement of Contracts §136 (1932), to whom an underlying duty of fair treatment is owed by the corporation or majority stockholders or controlling directors and officers thereof." Slip opinion, n. 19, pp. 4795-96.

Applying the standards of fiduciary behavior to the freeze-out sought to be perpetrated by those in control of Concord, one can have no doubt that the individual defendants have breached their obligations of trust to Concord and its public minority shareholders for their own personal interests.

III.

A PRELIMINARY INJUNCTION, NOT APPRAISAL, IS THE PROPER REMEDY WHEN DIRECTORS VIOLATE THE FEDERAL SECURITIES LAW, OR FAIL TO DISCHARGE THEIR FIDUCIARY DUTIES TO ACT IN THE INTEREST OF THE CORPORATION AND ALL ITS SHAREHOLDERS.

A. The Existence of Appraisal Rights Cannot Legitimitize an Unlawful Transaction.

State appraisal statutes are an anachronism responsive to an old common law rule which required unanimous approval by all shareholders of certain types of corporate transactions not in the ordinary course of business. They vary considerably from state to state and are regarded by most serious commentators, to say nothing of litigants who have sought to assert rights thereunder, as an inordinately expensive and utterly impractical means of protecting minority shareholders under the best of circumstances.

The court below disregarded recent cases which have determined not to relegate minority shareholders to the illusory appraisal remedy (which, in any event, is no remedy for the corporation itself in a derivative action), but have invoked the broad powers of equity to prevent freeze-out mergers where no business purpose is shown. Bryan v. Brock & Blevins Co. Inc., 490 F.2d 563 (5th Cir), reh. en banc. denied, 493 F.2d 664,

cert. denied, 419 U.S. 844 (1974); Albright v. Bergendahl, [74-75 Transfer Binder] CCH Fed. Sec. L. Rep., ¶94,997 (D. Utah, Sept. 5, 1974); and People v. Concord Fabrics, Inc. N.Y.L.J., June 13, 1975, p. 15, col. 2 (Sup. Ct. N.Y. Co.).

Professor Vorenberg in his widely-cited article "Exclusiveness of the Dissenting Stockholder's Appraisal Right", 77 Harv. L. Rev. 1189 (1964), after thorough analysis of the judicial precedents, concludes that there is no absolute right in a controlling stockholder to eliminate the minority, pointing out that the pivot on which the majority of cases turn is whether the freeze-out transaction serves a proper business purpose, as opposed to the mere jettisoning of minority shareholders. Thus, he states:

> "The purpose of this section has been to suggest that only where there is a plausible business purpose of the corporation beyond the majority's desire to enlarge their own stockholdings or to eliminate a minority stockholder should the minority holder be required to choose between what is available to him as a result of the action proposed by the majority and the cash value of his shares. Of course a rule which makes the purpose of a proposed corporate action significant is not self-applying; there will be many cases where courts will have difficulty judging the substantiality and genuineness of what is proposed." 77 Harv. L. Rev. at 1204.

In the instant case, defendants' concession that Concord has no business purpose for the proposed merger eliminates

the need for any inquiry into the substantiality and genuineness of what defendants have proposed and dispels any possible argument that the mere grant of appraisal rights somehow validates the transaction.

B. The District Court Misinterpreted The New York Authorities.

In holding, in the decision below, that the right of appraisal is the exclusive remedy for shareholders opposed to a long-form merger to be effected in formal compliance with the New York Business Corporation Law, the district court misinterpreted and erroneously relied upon two decisions, Beloff v. Consolidated Edison Company of New York, Inc., 300 N.Y. 11 (1949) and Willcox v. Stern, 18 N.Y.2d 195 (1966), both of which involved "short-form" mergers, and a third decision, Blumenthal v. Roosevelt Hotel Corp., 202 Misc. 988, 115 N.Y.S.2d 52 (Sup. Ct. 1952), which, unlike this case, did not involve a derivative claim against the expenditure of corporate assets for no business purpose.

Under the Business Corporation Law and predecessor New York statutes, a short-form merger, one in which a subsidiary at least 95% owned by its parent corporation is merged into its parent corporation, does not require the board of directors of the subsidiary to adopt a merger resolution, and the transaction is accomplished merely by action on the part of the parent. Such

mergers are governed by BCL § 905, rather than BCL §§ 902 and 903. In a short-form merger in New York, not only are no resolutions required from the directors of the subsidiary corporation, but, indeed, no action of any sort on the part of the subsidiary is required. Thus, the question of "business purpose" on the part of the subsidiary corporation is not involved. In such mergers, appraisal rights may, as held in Beloff and Willcox, suffice. However, it should be noted that even then, as the New York Court of Appeals clearly pointed out in Willcox, "equity *will* act -- despite the existence of an appraisal remedy -- where there is fraud or illegality...." (Emphasis by court.) 18 N.Y.2d at 204.

Even if it be assumed that Blumenthal would apply to a derivative cause of action, although such a cause of action was not there present, and that Blumenthal stands for the proposition that appraisal is an exclusive remedy, that decision has been narrowly limited, if not effectively overruled, by the subsequent decision of the New York Court of Appeals in Eisenberg v. Central Zone Property Corp., 306 N.Y. 58 (1953). There the New York Court of Appeals specifically held that the existence of an appraisal remedy would not validate an otherwise invalid transaction.

Although the Appellate Division had held in the Eisenberg case that "each of the major phases of the plan was

authorized by statute", 118 N.Y.S.2d 919 (1st Dept. 1953), the Court of Appeals reversed and held that the plan contemplated by defendants therein was illegal and that appraisal rights could not validate the plan. The Court of Appeals stated:

> "The sole other alternative of plaintiff, as respondent reads section 20 of the Stock Corporation Law, was to give up his investment, accept the appraisal value of his stock and get out of the New York Corporation so that the principal stockholders might sell all the stock of the first-to-be-formed Delaware Corporation, as a unit. The Legislature never sanctioned such treatment of a minority stockholder and, on application, equity will forbid it." (Emphasis by court.) 306 N.Y. at 67.

The New York Business Corporation Law codified the principles enunciated in Eisenberg by adding subdivision (k) to BCL § 623, which provides:

> "(k) The enforcement by a shareholder of his right to receive payment for his shares in the manner provided herein shall exclude the enforcement by such shareholder of any other right to which he might otherwise be entitled by viture of share ownership, except as provided in paragraph (e), and except that this section shall not exclude the right of such shareholder to bring or maintain an appropriate action to obtain relief on the ground that such corporate action will be or is unlawful or fraudulent as to him." (Emphasis supplied.)

The only case cited in the New York Legislative Studies and Reports in connection with the italicized portion of subdivision (k) as quoted above is Eisenberg, which stands for the

proposition that where the transaction is illegal, appraisal rights cannot legitimitize such transaction, and "on application, equity will forbid it." Yet, when application was made to the district court herein on the basis of New York law and specifically on the basis of the the decision in Eisenberg and BCL §623(k), it erroneously refused to grant a preliminary injunction.

Since the decision in Eisenberg, which put to rest the notion that appraisal rights can validate an otherwise invalid transaction, we know of no New York court which has held that appraisal was an exclusive or proper remedy where directors have breached their fiduciary duties to a corporation.

Defendants can be expected to urge that Mr. Justice Markowitz's decision in People v. Concord Fabrics,Inc., in which he rejected the defendants' contention that appraisal is an exclusive remedy, merely involved the police power of the State of New York under the New York "blue sky" statutes, and is, therefore, inapplicable to private suits by shareholders. However, the cases cited by Mr. Justice Markowitz, and his analysis of those authorities, belie any such contention and show that his decision rests on fundamental principles established in civil litigation pertaining to the fiduciary obligations of corporate insiders. Indeed, if the Concord freeze-out merger is a "fraud" within

the meaning of a state statute which provides criminal sanctions where a far higher threshhold of wrongdoing applies, it most certainly is invalid for purposes of this civil litigation.

IV.

THE PROPOSED MERGER AND THE STEPS TAKEN IN CONNECTION THEREWITH VIOLATE SECTION 10(b).

Far more than a "perversion of the whole process of public financing" occurs when, as here, investors are enticed to purchase shares from a corporation and its insiders in a bullish market and are then forced when the market goes down to turn in those shares for no reason other than the desire of the insiders to once again own all of the stock. Such conduct is a *per se* manipulative and deceptive practice which this Court should condemn as a violation of Rule 10b-5. It falls squarely within the language of Section 10(b) of the Exchange Act which reads, in relevant part:

> "It shall be unlawful for any person, . . . to use or employ, in connection with the purchase and sale of any security . . ., any manipulative or deceptive device or contrivance . . ."

We recognize that the lower courts in this Circuit have chosen to limit their inquiry under the securities laws in going

private cases only to matters of disclosure. However, we urge that those decisions, inexplicable to lay investors separated from their money by avaricious corporate predators at both ends of the Dow-Jones average, have resulted from a misreading of this Court's decision in Popkin v. Bishop, 464 F.2d 714 (2d Cir. 1972), a failure to appreciate the force of other recent decisions of this Court under Section 10(b), and a lack of sensitivity to the inherently deceptive and manipulative nature of actions taken pursuant to an intention to go-private.

First, the frequently-quoted statement of this Court in Popkin that questions regarding "the wisdom of . . . transactions or even their fairness become tangential at best to federal regulations" cannot be read to extend to a situation involving a sham merger where the resolutions which are indispensable to the merger are themselves invalid since they lack any business purpose. There was no question in Popkin concerning invalidity by reason of lack of business purpose. Popkin dealt only with the fairness of merger terms, an area which this Court believed was best left for the state courts. This case, on the other hand, does not require analysis of the fairness of merger terms. We are not here arguing that it is the obvious inadequacy of the $3 per share price which invalidates the transaction. We are argu-

ing, however, that without a business purpose, the merger and the resolutions with respect thereto are void as a matter of law whatever the price offered may be.

Second, the decisions in this Circuit establish that Section 10(b) extends far enough to invalidate corporate action taken without a corporate purpose. For example, in Drachman v. Harvey, 453 F.2d 722 (2d Cir. 1972) (en banc), this Court held, on rehearing, that a derivative action stated a claim under Section 10(b) where the insiders had caused a corporation to purchase securities for no business purpose, but merely to perpetuate their control. The charge was made that the transaction "depleted the assets of the corporation to the detriment of the company and the remaining shareholders." 453 F.2d at 734. As stated by Judge Smith:

> "The only distinction that I can see between the present case and Schoenbaum is that here the directors of Harvey, influenced by a conflict of interest and acting to support Martin's controlling interest, caused the corporation to be a 'forced purchaser' rather than a 'forced seller.' In each case the corporation sustained damage-in Schoenbaum Banff received inadequate consideration for its stock, where as here Harvey was subjected to a loss of working capital and obliged to pay substantially higher interest rates. Following Schoenbaum, therefore, I would find that the appellants have successfully made out a section 10(b) claim." 453 F.2d at 735.

Although the foregoing language is contained in Judge Smith's dissent from the panel opinion in Drachman, it is the clear holding of the case, as may be seen from the en banc opinion, where Judge Smith stated "... a sufficient claim is stated of fraud against the corporaton in connection with the redemption of the debentures, a 'purchase' within the meaning of the statute and rule." 453 F.2d at 737. Plainly, then, if the redemption of the debentures without a business purpose in Drachman gave rise to a derivative claim under Section 10(b) since it subjected the corporation to a loss of working capital, then the attempt here to effect a retirement of a corporation's common stock by the elimination of its public shareholders through the means of a sham merger and the use of the corporation's funds gives rise to a derivative claim under Section 10(b) to enjoin the consummation of the transaction.

Third, this Court has recognized that a course of conduct leading to a merger can be inherently manipulative and deceptive even before the issuance of a proxy statement. In holding that so long as the proxy statement is not misleading, there can be no violation of Rule 10b-5, the district court did not give proper effect to this Court's decision in Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374 (2d Cir. 1974), cert. denied,

U.S. (1975), where, as here, the violation of the federal securities laws occurred prior to the dissemination of the proxy statement. Indeed, the Marshel action was commenced on February 28, 1975, and an amended complaint was filed on March 11, 1975, whereas the proxy statement was not issued until March 17, 1975.

Although not mentioned by the district court, paragraph 24 of the amended complaint alleged that defendants had, among other things, artificially depressed the market price of shares of Concord common stock by "causing Concord to refrain from declaring any cash dividends, although Concord had and continues to have large sums of cash and other liquid assets which are unnecessary for its operation of business". (12-13). The truth of this allegation is evident from defendants' willingness, indeed desire, to have Concord expend over $1,600,000 to buy up the public's stockholdings -- and reduce Concord's net worth by that amount -- for no business reason. If Concord has surplus funds available to retire public shareholdings for the benefit of the insiders, the Weinsteins, Concord has at least the same amount of funds available for the payment of dividends for the benefit of all shareholders of Concord.

The withholding of dividends for the purpose of depressing the market price for a corporation's shares especially when

coupled with insiders' desire to eliminate the public shareholdings at a reduced price states a claim for injunctive relief under Rule 10b-5. The correctness of this legal conclusion is clear from this Court's holding in Mutual Shares Corporation v. Genesco, Inc., 384 F.2d 540, 546 (2d Cir. 1967), wherein this Court stated:

> "However, the complaint does charge that in this later period defendants manipulated the market price of Kress stock, keeping Kress dividends to a minimum, in order to force minority stockholders to sell out to Genesco at depressed values. While not highlighted in this court, the contention that this states a claim under Rule 10b-5 is substantial. Controlling stockholders have a duty not to take advantage of the minority in purchasing the latter's shares. See Speed v. Transamerica Corp., 99 F.Supp. 808, 828-829 (D. Del. 1951). In Cochran v. Channing Corp., 211 F.Supp. 239 (S.D. N.Y. 1962), it was held that manipulation of market price and purposeful reduction of dividends in order to buy out minority stockholders cheaply was actionable under Rule 10b-5, at least under subdivisions (1) and (3) thereof. Moreover, this court referred approvingly to that holding in O'Neill v. Maytag, 339 F.2d 764, 768 (2d Cir. 1964), stating that:
>
> > In addition, deception may take the form of nonverbal acts: In Cochran v. Channing Corp., 211 F.Supp. 239 (S.D.N.Y. 1962), it consisted of reducing dividends in order to drive down the price of the corporation's stock. And it need not be deception in any restricted

common law sense; one of the central purposes of federal securities legislation would otherwise be seriously vitiated.

* * *

"...we do not regard the fact that plaintiffs have not sold their stock as controlling on the claim for injunctive relief. The complaint alleges a manipulative scheme which is still continuing."

In the instant case, the burden was plainly upon defendants to explain away how Concord is suddenly able to expend over $1,600,000 for a non-business purpose but yet had ceased paying dividends. The inference of an intent to depress the market price by the lack of any cash dividends is surely sufficiently strong to warrant the grant of a preliminary injunction on this allegation. Particularly is this so when -- lack of business purpose having been conceded -- there was no pressing need for the merger to be consummated before the issue could be tried.

As this Court set forth in <u>Gulf & Western Industries, Inc.</u> v. <u>Great Atlantic & Pacific Tea Co.</u>, 476 F.2d 687, 699 (2d Cir. 1973):

"[D]oubts as to whether an injunction sought is necessary to safeguard the public interest -- when the public interest involved is as clear, pervasive and vital as the record here demonstrates -- should be resolved in favor of granting the injunction."

In the case at bar, it is submitted that there are no "doubts". Defendants have conceded that their actions are without a business purpose. Such concession is tantamount to an admission of impropriety. Their conduct violates both federal and state law and should be enjoined.

CONCLUSION

The order of the district court denying a preliminary injunction should be reversed and the injunction directed to issue.

Respectfully submitted,

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Justice Markowitz

PEOPLE, &C., v. CONCORD FABRICS, INC.—This is a motion by the State of New York for an injunction, pendente lite, seeking in effect to prevent the effectuating of a corporate merger. Defendant Concord Fabrics, Inc., a New York corporation, went "public" in 1968 with the sale of $4,500,000 worth of common stock. The following year, a second issue was offered to the public which brought in an additional $4,000,000. The book value of the publicly-offered shares varied at the time of the offerings between $6.75 and $7.15 a share. The market price declined from a high of $25 a share to about $1 a share at the end of 1974. Some time in 1974, the individual defendants decided to go "private" and return full ownership and control of the shares in the corporation to the Weinstein family. To accomplish this purpose, the Weinstein group formulated a new corporation called AFW Fabric Corp. At that time the Weinstein group, through personal ownership and through trusts they controlled as fiduciaries, represented 68 per cent of the outstanding shares of Concord. These shares were transferred to AFW. In turn AFW transferred its total outstanding stock to the Weinstein group.

About the same time, the Weinstein's engaged the underwriting firm of Shearson Hayden Stone Inc. to render an appraisal for a proposed tender-offering merger. The appraisal resulted in a figure of $3 a share. It appears that the appraiser was the son of a director of Concord. In early February of this year, a tender offer was actually made to the public shareholders of Concord by AFW. Litigation which ensued, however, forced withdrawal of the tender offer. Instead, a notice of meeting was called by Concord to approve a plan of merger at a meeting scheduled for April 10, 1975. The proxy statement, accompanying the notice, unabashedly states that the purpose of the proposed merger of AFW into Concord "is to return the Company to the status of a privately-held corporation owned by the Weinstein family. Upon consummation of the merger, the Weinstein's will be the sole stockholders and directors of the Company, and will thus be able to determine all policies of the Company, such as salaries for themselves and others, dividends and business activities, without public scrutiny and solely with regard to their own interests." The plan also advised minority shareholders that they must either accept $3 per share for their stock, or resort to judicial proceedings as contemplated under section 910 of the Business Corporation Law for appraisal of their holdings. It is also stated in the plan of merger that:

"AFW owns more than the percentage of the Company's Common Stock required to approve the merger and intends to vote such stock in favor of the merger. Accordingly, the other shareholders of the Company will be unable to defeat approval of the merger by voting against it and thus may either accept $3 per share in cash or exercise their appraisal rights."

Upon completion of the merger, AFW's corporate existence will cease. The merger plan is to be financed by credit advanced to Concord.

The sole issue here is whether the state has an interest in investigating and seeking to have vitiated a proposed merger or freeze out of minority stockholders under its police power, where proper grounds exist.

Under Federal law, it has been generally held that minority stockholders in freeze-out situations are relegated to their right of appraisal where a corporate purpose in going private is shown and where there has been full disclosure (Dreier v. The Music Makers Group, Inc. [SDNY, Feb. 20, 1974], CCH Fed. Securities Law Reporters, par. 94, 406; Tanzer Economic Associates v. Haynie [S. D., N. Y., Nov. 20, 1974, Civ. 4354], CCH Fed. Securities Law Reporters, par. 94, 873; cf., Albright v. Bergendahl [D. C., Utah, Sept. 5, 1974], CCH Fed. Securities Law Reporters, par. 94, 997).

This treatment of minority stockholders has been severely criticized by a U. S. Security and Exchange Commissioner in a speech wherein he stated:

"Faced with the prospect of a force-out merger, or a market reduced to glacial activity and the liquidity of the Mojave Desert and deprived of most of the benefits of the * * * securities laws, how real is the choice of the shareholder confronting the offer of management to acquire his shares, usually not with their own resources, but with the corporation's resources that really belong to him and his fellow shareholders?" (A. A. Sommer, Jr., "Going Private": A lesson in corporate responsibility).

The SEC has sought to inject standards of fairness through the application of Federal securities laws. However, these laws do not seem sufficiently broad to deal with the problem of going private.

In this state, the fiduciary relation between managing stockholders and controlling stockholders and minority stockholders has long been recognized (Kavanaugh v. Kavanaugh Knitting Co., 226 N. Y., 185).

The court in Kavanaugh, supra, upheld a cause of action based upon an inference that those in control "conceived and progressed the scheme of dissolving the corporation irrespective of the welfare or advantage of the corporation and of any cause or reason related to its condition or future, through the desire and determination to take from the corporation and to secure to themselves the corporate business, freed from interference or participation on the part of the plaintiff" (p. 197).

In Blumenthal v. Roosevelt Hotel, Inc. (Supreme Court, N. Y. County, 1952), 202 Misc. 988, in a situation strikingly similar to the one at bar, it was held that where a "freeze out" of minority stockholders is attempted, the court will relegate the dissenting shareholders to their appraisal rights where it is shown that bad faith is merely charged generally, "but otherwise the classic elements of fraud are not spelled out" (p. 989).

In reaching its conclusion, the court in Blumenthal stated, "The principles stated in the Kavanaugh case (supra) are sound principles of law and equity, but the situation that we have in the instant case is not the same that involved in the Kavanaugh matter" (p. 990).

Since Blumenthal, there appears to have been a broadening concept of fiduciary obligations of majority to minority stockholders, so that in Williams v. Bartell, 34 Misc. 2d 553, modified 16 A. D. 2d 21, there appears to have been a balancing of the equities between whether dissenting shareholders must be relegated to actions at law or obtain relief in equity, depending on the peculiar circumstances and exigencies of a given situation.

The instant proceeding is brought not by individuals, but under article 23A of the General Business Law, which is commonly known as the Martin Act, or the New York State "Blue Sky Law." Section 352 of the General Business Law empowers the attorney general.

"Whenever it shall appear to the attorney-general, either upon complaint or otherwise, that * * * in the issuance, exchange, purchase, sale, promotion, negotiation, advertisement, investment advice or distribution within or from this state, of any stocks, bonds, notes, evidences of interest or indebtedness or other securities * * * any person, partnership, corporation, company, trust or association * * * shall have employed or employs, or is about to employ, any device, scheme or artifice to defraud or for obtaining money or property by means of any false pretense, representation or promise, or that any person, partnership, corporation, company, trust or association, or any agent or employee thereof shall have made, makes or attempts to make, within or from this state, fictitious or pretended purchases or sales of securities or commodities or that any person, partnership, corporation, company, trust or association or agent or employees thereof shall have employed, or employs, or is about to employ, any deception, misrepresentation, concealment, suppression, fraud, false pretense or false promise, or shall have engaged in or engages in or is about to engage in any practice or transaction or course of business relating to the purchase, exchange, investment advice or sale of securities or commodities which is fraudulent or in violation of law and which has operated or which would operate as a fraud upon the purchase * * * any one or all of which devices, schemes, artifices, fictitious or pretended purchases or sales of securities or commodities, deceptions, misrepresentations, concealments, suppressions, fraud, false pretenses, false promises, practices, transactions and courses of business are hereby declared to be and are hereinafter referred to as a fraudulent practice or fraudulent practices * * *."

Where such investigation uncovers to the satisfaction of the attorney general that barred practices have been engaged in, he is authorized under section 353 of the General Business Law to bring an action in the name and on behalf of the People of the state to enjoin such allegedly "fraudulent practices." Paternalistic in its design, the Martin Act was adopted to protect the public against exploitation by visionary schemes and other fraudulent practices respecting stocks, bonds and other securities (People v. Federated Radio Corp., 244 N. Y. 33; People v. Tellier, 7 Misc 2d 43).

The fraudulent practices, which are the target of the Martin Act, need not be fraud in the classic sense since, pursuant to the Act, the absence of scienter or intent to defraud does not relieve a defendant from liability (People v. Federated Radio Corp., supra; People v. Royal Securities Corp., 5 Misc 2d 907).

It would thus appear that under the broad powers afforded the attorney general, under article 23A of the General Business Law, the security transactions such as are involved in this proceeding are proper targets for his scrutiny despite the fact that full disclosure of the aims of the Weinstein group have been articulated. What is disquietingly evident here is the fact that a group of insiders who are directing the reacquisition program, even controlling the appraisal of the stock are the very ones who made the company public originally, and will be the surviving shareholders in the proposed privately-held enterprise. Adding to the odium of the scheme is that fact that no real corporate purpose has been demonstrated and that the credit of a now public corporation will be used to finance a merger for the benefit of a private group.

Equity mandates fairness in all human transactions. In this state, the legislature has seen fit to empower the attorney general to scrutinize security transactions so that wrong may be averted and that the small investor will not be prey to a self-interested majority either in going public or private. For this reason the motion for temporary injunction is in all respects granted. Settle order.

ADDENDUM OF STATUTES, ETC.

Securities Exchange Act of 1934:

"Sec. 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange-

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

General Rules and Regulations under the Securities Exchange Act of 1934:

"Rule 10b-5. Employment of Manipulative and Deceptive Devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

New York Business Corporation Law:

§ 202. General powers

(a) Each corporation, subject to any limitations provided in this chapter or any other statute of this state or its certificate of incorporation, shall have power in furtherance of its corporate purposes:

(1) To have perpetual duration.

(2) To sue and be sued in all courts and to participate in actions and proceedings, whether judicial, administrative, arbitrative or otherwise, in like cases as natural persons.

(3) To have a corporate seal, and to alter such seal at pleasure, and to use it by causing it or a facsimile to be affixed or impressed or reproduced in any other manner.

(4) To purchase, receive, take by grant, gift, devise, bequest or otherwise, lease, or otherwise acquire, own, hold, improve, employ, use and otherwise deal in and with, real or personal property, or any interest therein, wherever situated.

(5) To sell, convey, lease, exchange, transfer or otherwise dispose of, or mortgage or pledge, or create a security interest in, all or any of its property, or any interest therein, wherever situated.

(6) To purchase, take, receive, subscribe for, or otherwise acquire, own, hold, vote, employ, sell, lend, lease, exchange, transfer, or otherwise dispose of, mortgage, pledge, use and otherwise deal in and with, bonds and other obligations, shares, or other securities or interests issued by others, whether engaged in similar or different business, governmental, or other activities.

(7) To make contracts, give guarantees and incur liabilities, borrow money at such rates of interest as the corporation may determine, issue its notes, bonds and other obligations, and secure any of its obligations by mortgage or pledge of all or any of its property or any interest therein, wherever situated.

(8) To lend money, invest and reinvest its funds, and take and hold real and personal property as security for the payment of funds so loaned or invested.

(9) To do business, carry on its operations, and have offices and exercise the powers granted by this chapter in any jurisdiction within or without the United States.

(10) To elect or appoint officers, employees and other agents of the corporation, define their duties, fix their compensation and the compensation of directors, and to indemnify corporate personnel.

(11) To adopt, amend or repeal by-laws, including emergency by-laws made pursuant to subdivision seventeen of section twelve of the state defense emergency act,[1] relating to the business of the corporation, the conduct of its affairs, its rights or powers or the rights or powers of its shareholders, directors or officers.

(12) To make donations, irrespective of corporate benefit, for the public welfare or for community fund, hospital, charitable, educational, scientific, civic or similar purposes, and in time of war or other national emergency in aid thereof.

(13) To pay pensions, establish and carry out pension, profit-sharing, share bonus, share purchase, share option, savings, thrift and other retirement, incentive and benefit plans, trusts and provisions for any or all of its directors, officers and employees.

(14) To purchase, receive, take, or otherwise acquire, own, hold, sell, lend, exchange, transfer or otherwise dispose of, pledge, use and otherwise deal in and with its own shares.

(15) To be a promoter, partner, member, associate or manager of other business enterprises or ventures, or to the extent permitted in any other jurisdiction to be an incorporator of other corporations of any type or kind.

(16) To have and exercise all powers necessary or convenient to effect any or all of the purposes for which the corporation is formed. L.1961, c. 855; amended L.1962, c. 831, § 5; L.1963, c. 748, § 3, all eff. Sept. 1, 1963.

§ 623. Procedure to enforce shareholder's right to receive payment for shares

* * *

(k) The enforcement by a shareholder of his right to receive payment for his shares in the manner provided herein shall exclude the enforcement by such shareholder of any other right to which he might otherwise be entitled by virtue of share ownership, except as provided in paragraph (e), and except that this section shall not exclude the right of such shareholder to bring or maintain an appropriate action to obtain relief on the ground that such corporate action will be or is unlawful or fraudulent as to him.

§ 717. Duty of directors and officers

Directors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions. In discharging their duties, directors and officers, when acting in good faith, may rely upon financial statements of the corporation represented to them to be correct by the president or the officer of the corporation having charge of its books of accounts, or stated in a written report by an independent public or certified public accountant or firm of such accountants fairly to reflect the financial condition of such corporation. L.1961, c. 855, eff. Sept. 1, 1963.

§ 902. Plan of merger or consolidation

(a) The board of each corporation proposing to participate in a merger or consolidation under section 901 (Power of merger or consolidation) shall adopt a plan of merger or consolidation, setting forth:

(1) The name of each constituent corporation and, if the name of any of them has been changed, the name under which it was formed; and the name of the surviving corporation, or the name, or the method of determining it, of the consolidated corporation.

(2) As to each constituent corporation, the designation and number of outstanding shares of each class and series, specifying the classes and series entitled to vote and further specifying each class and series, if any, entitled to vote as a class; and, if the number of any such shares is subject to change prior to the effective date of the merger or consolidation, the manner in which such change may occur.

(3) The terms and conditions of the proposed merger or consolidation, including the manner and basis of converting the shares of each constituent corporation into shares, bonds or other securities of the surviving or consolidated corporation, or the cash or other consideration to be paid or delivered in exchange for shares of each constituent corporation, or a combination thereof.

(4) In case of merger, a statement of any amendments or changes in the certificate of incorporation of the surviving corporation to be effected by such merger; in case of consolidation, all statements required to be included in a certificate of incorporation for a corporation formed under this chapter, except statements as to facts not available at the time the plan of consolidation is adopted by the board.

(5) Such other provisions with respect to the proposed merger or consolidation as the board considers necessary or desirable.

As amended L.1965, c. 803, § 37.

§ 903. Authorization by shareholders

(a) The board of each constituent corporation, upon adopting such plan of merger or consolidation, shall submit such plan to a vote of shareholders in accordance with the following:

(1) Notice of meeting shall be given to each shareholder of record, as of the record date fixed pursuant to section 604 (Fixing record date), whether or not entitled to vote. A copy of the plan of merger or consolidation or an outline of the material features of the plan shall accompany such notice.

(2) The plan of merger or consolidation shall be adopted at a meeting of shareholders by vote of the holders of two-thirds of all outstanding shares entitled to vote thereon. Notwithstanding any provision in the certificate of incorporation, the holders of shares of a class or series shall be entitled to vote and to vote as a class if the plan of merger or consolidation contains any provision which, if contained in an amendment to the certificate of incorporation, would entitle the holders of shares of such class or series to vote and to vote as a class thereon. In such case, in addition to the authorization of the merger or consolidation by vote of the holders of two-thirds of all outstanding shares entitled to vote thereon, the merger or consolidation shall be authorized by vote of the holders of a majority of all outstanding shares of each such class or series.

(b) Notwithstanding shareholder authorization and at any time prior to the filing of the certificate of merger or consolidation, the plan of merger or consolidation may be abandoned pursuant to a provision for such abandonment, if any, contained in the plan of merger or consolidation.

As amended L.1965, c. 803, § 38.

§ 905. Merger of subsidiary corporation

(a) Any domestic corporation owning at least ninety-five percent of the outstanding shares of each class of another domestic corporation or corporations may merge such other corporation or corporations into itself without the authorization of the shareholders of any such corporation. Its board shall adopt a plan of merger, setting forth:

(1) The name of each subsidiary corporation to be merged and the name of the surviving corporation, and if the name of any of them has been changed, the name under which it was formed.

(2) The designation and number of outstanding shares of each class of each subsidiary corporation to be merged and the number of such shares of each class owned by the surviving corporation; and if the number of any such shares is subject to change prior to the effective date of the merger, the manner in which such change may occur.

(3) The terms and conditions of the proposed merger, including the manner and basis of converting the shares of each subsidiary corporation to be merged not owned by the surviving corporation into shares, bonds or other securities of the surviving corporation, or the cash or other consideration to be paid or delivered in exchange for shares of each such subsidiary corporation, or a combination thereof.

(4) Such other provisions with respect to the proposed merger as the board considers necessary or desirable.

(b) A copy of such plan of merger or an outline of the material features thereof shall be given, personally or by mail, to all holders of shares of each subsidiary corporation to be merged not owned by the surviving corporation, unless the giving of such copy or outline has been waived by such holders.

(c) A certificate of merger, entitled "Certificate of merger of .... into .... (names of corporations) under section 905 of the Business Corporation Law", shall be signed, verified and delivered to the department of state by the surviving corporation. If the surviving corporation does not own all shares of each subsidiary corporation to be merged, such certificate shall be delivered not less than thirty days after the giving of a copy or outline of the material features of the plan of merger to shareholders of each such subsidiary corporation, or at any time after the waiving thereof by the holders of all of the outstanding shares of each such subsidiary corporation not owned by the surviving corporation. The certificate shall set forth:

(1) The statements required by subparagraphs (a) (1) and (2) of this section.

(2) The effective date of the merger if other than the date of filing of the certificate of merger by the department of state.

(3) The date when the certificate of incorporation of each constituent corporation was filed by the department of state.

(4) A statement that the plan of merger was adopted by the board of directors of the surviving corporation.

(5) If the surviving corporation does not own all the shares of each subsidiary corporation to be merged, either the date of the giving to holders of shares of each such subsidiary corporation not owned by the surviving corporation of a copy of the plan of merger or an outline of the material features thereof, or a statement that the giving of such copy or outline has been waived, if such is the case.

(d) The surviving corporation shall thereafter cause a copy of such certificate, certified by the department of state, to be filed in the office of the clerk of each county in which the office of a constituent corporation, other than the surviving corporation, is located, and in the office of the official who is the recording officer of each county in this state in which real property of a constituent corporation, other than the surviving corporation, is situated.

(e) The right of merger granted by this section to certain corporations shall not preclude the exercise by such corporations of any other right of merger or consolidation under this article.

As amended L.1965, c. 803, §§ 40–42; L.1966, c. 626; L.1969, c. 401, § 2.

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Date 7/28/75

KAYE, SCHOLER, FIERMAN, HAYS & HANDLER

Attorney(s) for Defendant-Appellees